

ORIGINAL
No. 7734

United States
Circuit Court of Appeals

For the Ninth Circuit.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

THE PROCTOR SHOP, INC.,
Respondent.

Transcript of the Record

Upon Petition to Review an Order of the United States
Board of Tax Appeals.

FILED

FEB - 4 / 1935

PAUL P. O'BRIEN,
CLERK

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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APPEARANCES:

For Petitioner:

W. W. SPALDING, Esq.,
ROSCOE C. NELSON, Esq.

For Respondent:

W. F. WATTLES, Esq.

Docket No. 58909

THE PROCTOR SHOP, INC.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DOCKET ENTRIES:

1931

June 10—Petition received and filed. Taxpayer notified. (Fee paid)

June 10—Copy of petition served on General Counsel.

July 17—Answer filed by General Counsel.

July 27—Copy served—assigned General Calendar.

1933

Feb. 3—Hearing set March 7, 1933.

Feb. 15—Motion for circuit hearing at Portland, Oregon filed by taxpayer. 2/17/33 granted.

Aug. 5—Hearing set 9/25/33 at Portland, Oregon.

Sept. 20—Application for subpoena of M. H. Holtz filed by General Counsel (subpoena duces tecum).

1933

- Sept. 20—Subpoena issued.
- Sept. 28—Hearing had before Mr. Arundell—submitted. Consolidated with 66268. Briefs due Nov. 10, 1933—without exchange.
- Oct. 20—Transcript of hearing of 9/28/33 filed.
- Nov. 8—Brief filed by taxpayer.
- Nov. 8—Motion for extension to Dec. 20, 1933 to file proposed findings of fact and brief filed by General Counsel. 11/9/33 granted.
- Dec. 20—Brief filed by General Counsel.

1934

- Jan. 30—Motion for leave to file reply brief filed by taxpayer—reply brief lodged. 1/31/34 granted.
- Feb. 15—Motion for leave to file a reply brief, brief tendered, filed by General Counsel. 2/20/34 granted.
- May 16—Findings of fact and opinion rendered—C. R. Arundell, Division 7. Decision will be entered under Rule 50.
- June 15—Notice of settlement filed by General Counsel.
- June 18—Hearing set July 11, 1934 under Rule 50.
- July 3—Consent to settlement filed by taxpayer.
- July 11—Decision entered—Division 7.
- Oct. 5—Petition for review by U. S. Circuit Court of Appeals (9) with assignments of error filed by General Counsel.
- Oct. 16—Proof of service filed.
- Dec. 4—Motion for extension to 2/5/35 to complete record filed by General Counsel.

1934

Dec. 4—Order enlarging time to 2/5/35 to prepare evidence and deliver record entered.

Dec. 13—Agreed praecipe filed—proof of service thereon. [1*]

United States Board of Tax Appeals

Docket No. 58909

THE PROCTOR SHOP, INCORPORATED,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION.

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (IT:AR:E-3-JAH-60D) dated April 30, 1931, and as a basis of its proceeding alleges as follows:

1. The petitioner is a corporation with its principal office at 331 Washington Street, Portland, Oregon.

2. The notice of deficiency (a copy of which is attached and marked Exhibit "A") was mailed to the petitioner on April 30, 1931.

3. The taxes in controversy are income taxes for [2] the fiscal year ended January 31, 1929 and for \$3,878.99, all of which is in dispute.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) The net income for the taxable year is overstated by \$17,327.36, representing the statutory net loss sustained by petitioner in that amount for its previous taxable year ended January 31, 1928, which respondent has erroneously disallowed as hereinafter outlined.

(b) The net income for the taxable year is further overstated by \$19,930.25, representing deductions claimed for that year and erroneously disallowed by respondent, as hereinafter stated.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) The petitioner was organized and incorporated under the laws of the State of Oregon on October 6, 1927, after having purchased the assets of Proctor's Incor- [3] porated, as of September 30, 1927. Petitioner established a fiscal year ended January 31st and its accounts have been kept and its income tax returns rendered on that basis since its organization in October, 1927.

For its first taxable year ended January 31, 1928, petitioner's books and tax return showed an operating and statutory net loss of \$17,822.84, which amount was carried forward and deducted on petitioner's return for the fiscal year ended January 31, 1929. The respondent has converted this net loss for 1928 into a so-called net income of \$1,648.16 by disallowing the following deductions claimed by petitioner:

Net loss reported by petitioner		\$17,822.84
Additions by respondent:		
1. Reserves for bad debts		
disallowed	\$12,995.52	
2. Interest disallowed	1,980.00	
3. Officer's salary disallowed	4,000.00	
4. Organization expenses	495.48	19,471.00
		<hr/>
Net income shown by respondent—		\$ 1,648.16
		<hr/> <hr/>

With the exception of the item of organization expenses (\$495.48) the foregoing adjustments are erroneous for the following reasons: [4]

1. Among the assets purchased by petitioner from Proctor's, Incorporated, were accounts receivable amounting to \$124,686.36. At the end of its first fiscal year, January 31, 1928, petitioner adopted the method of setting up a reserve for bad debts to cover the estimated accounts that were uncollectible. Specifically, petitioner listed at the close of its fiscal year all accounts on which no collection had been made within the preceding four months and increased the reserve by \$18,421.13 to cover the amount of such accounts which the petitioner believed would be uncollectible. The respondent has reduced the provision at January 31, 1928, to \$5,425.61 by arbitrarily computing the reserve on a basis of $2\frac{3}{4}\%$ of sales. The petitioner, on information and belief based on its actual experience, alleges that the addition to reserve for bad debts of \$18,421.13 at January 31, 1928, is no more than a reasonable addition to the reserve and that the

amount allowed by respondent is wholly insufficient to take care of the bad debts.

2. When the petitioner was organized it issued \$1,000 in common stock and \$99,000 was loaned to it by Aaron Holtz, to whom Debenture Preference Stock was issued in that [5] amount. The certificate evidencing this so-called stock specifically specified that 6% interest per annum was to be paid to Mr. Holtz on the \$99,000 secured from him, said interest to be payable quarterly before any dividends were paid on the common stock. The petitioner has at all times considered this \$99,000 as being a loan to it and has consistently since its organization credited Mr. Holtz on its books monthly with interest at 6% on this amount of indebtedness and deducted same as an expense. The amount of such interest accrued on its books and paid to Mr. Holtz during the taxable period ended January 31, 1928 amounted to \$1,980. This amount which was in turn deducted on the tax return was allowed as a deduction by the examining revenue agent but respondent has disallowed said deduction on the erroneous assumption that it represented a dividend.

3. During the taxable year ended January 31, 1928, the petitioner agreed to and did pay M. H. Holtz, its President and General Manager, a salary of \$2,500 per month for his services. Pursuant to this agreement there was credited on petitioner's books to said M. H. Holtz the sum of \$2,500 monthly [6] for each of the four months October to January, comprising the taxable year ended January 31, 1928, or a total of \$10,000. This amount (\$10,000) was

paid solely for services rendered by Mr. Holtz, who devoted all his time to petitioner's business. It bears no relation to the stock owned by him and is no more than reasonable compensation for the services actually performed. Notwithstanding these facts, respondent has arbitrarily reduced this compensation by \$4,000.

When the aforesaid three items, \$12,995.52 reserves for debts, \$1,980 interest paid on indebtedness, and \$4,000 salary, disallowed as deductions by respondent, have been restored as deductions, there will be an operating statutory net loss of \$17,327.36 for the taxable period ended January 31, 1928, which is properly allowable as a deduction for the succeeding taxable year here involved, viz., the year ended January 31, 1929.

(b) In addition to the net loss sustained for the taxable year ended January 31, 1928, as above outlined, which was disallowed as a deduction, the respondent further increased the net income for the taxable year ended January 31, 1929 by disallowing the following deductions taken on the return: [7]

1. Interest disallowed	\$ 5,940.00
2. Officer's salary disallowed	12,000.00
3. Reserves for bad debts disallowed	1,990.25
	<hr/>
	\$19,930.25
	<hr/> <hr/>

1. During the taxable year ended January 31, 1929, petitioner credited on its books interest in the amount of \$5,940 to the account of Aaron Holtz and charged the same to interest. This amount represents 6% on the \$99,000 described in paragraph

5(a) (2) above. Said interest was credited monthly and was included in the income tax return rendered by said Aaron Holtz as interest received by him. For the reasons stated in said paragraph 5(a) (2) above, petitioner claims that respondent erred in disallowing this deduction and in treating it as a dividend.

2. During the taxable year ended January 31, 1929, petitioner paid to M. H. Holtz, its President and General Manager, a salary of \$2,500 per month, a total of \$30,000 for services rendered. This amount was paid to Mr. Holtz in accordance with an agreement entered into with him when he was employed by the petitioner in 1927, as stated in paragraph 5(a) (3) above. This amount (\$30,000) was paid solely for [8] services rendered by Mr. Holtz. It bears no relation to the stock owned by him and is no more than reasonable compensation for the services actually performed. The respondent has arbitrarily reduced this compensation by \$12,000.

3. As stated in paragraph 5(a) (1) above, the petitioner adopted the reserve method of charging off bad debts immediately after its organization in 1927, and has since consistently followed this method. At the end of the taxable year 1928 it added \$18,421.13 to this reserve, and at the end of the taxable year 1929 (the year here involved) it added \$16,961.42 to this reserve. In arriving at these amounts the petitioner took into consideration only the doubtful accounts on which no payments had been made for a considerable time prior to the

date of the close of the taxable year. Based upon the experience of petitioner it is believed that the amount of \$16,961.42 added to the bad debt reserve for the year ended January 31, 1929, is reasonable and no more than sufficient to cover the uncollectible accounts. The respondent has reduced this amount by \$1,990.25 by arbitrarily fixing the reserve on the basis of $2\frac{3}{4}\%$ of sales.

WHEREFORE, petitioner prays that this Board may hear the proceeding; that it be held by the Board that the [9] errors above mentioned were made by respondent; and for such other relief as may appear equitable and proper as this cause progresses.

W. W. SPALDING,

Counsel for Petitioner,
1021 Tower Building,
Washington, D. C.

State of Oregon,
County of Multnomah—ss.

MERRIMAN H. HOLTZ, being duly sworn, says that he is President of The Proctor Shop, Inc., the petitioner herein, and as such is duly authorized to verify the foregoing petition; that he has read the said petition and is familiar with the statements contained therein, and that the facts stated are true, except as to those facts stated to be upon information and belief, and those facts he believes to be true.

MERRIMAN H. HOLTZ [10]

Subscribed and sworn to before me this 4 day of June, 1931.

[Notarial Seal]

E. E. DUNBAR,
Notary Public.

My commission expires Apr. 23, 1934. [11]

EXHIBIT "A"

COPY

TREASURY DEPARTMENT

Washington

Apr. 30, 1931.

The Proctor Shop, Incorporated,
331 Washington Street,
Portland, Oregon.

Sirs:

You are advised that the determination of your tax liability for the fiscal year ended January 31, 1929 discloses a deficiency of \$3,878.99, as shown in the statement attached.

In accordance with section 272 of the Revenue Act of 1928, notice is hereby given of the deficiency mentioned. Within sixty days (not counting Sunday as the sixtieth day) from the date of the mailing of this letter, you may petition the United States Board of Tax Appeals for a redetermination of your tax liability.

HOWEVER, IF YOU DO NOT DESIRE TO PETITION, you are requested to execute the enclosed agreement form and forward it to the Commissioner of Internal Revenue, Washington, D. C.,

for the attention of IT:C:P-7. The signing of this agreement will expedite the closing of your return by permitting an early assessment of any deficiency and preventing the accumulation of interest charges, since the interest period terminates thirty days after filing the enclosed agreement, or on the date assessment is made, whichever is earlier; WHEREAS IF NO AGREEMENT IS FILED, interest will accumulate to the date of assessment of the deficiency.

Respectfully,
DAVID BURNET,
Commissioner,
By (Signed) J. C. WILMER,
Deputy Commissioner.

Enclosures:

- Statement
- Form 882
- Form 870. [12]

STATEMENT

IT:AR:E-3
JAH-60D

In re: The Proctor Shop, Incorporated,
331 Washington Street,
Portland, Oregon.

TAX LIABILITY

Fiscal Year Ended	Tax Liability	Tax Assessed	Tax Deficiency
January 31, 1928	\$ None	\$ None	\$ None
January 31, 1929	3,878.99	None	3,878.99
Total	<u>\$3,878.99</u>	<u>None</u>	<u>\$3,878.99</u>

Reference is made to the reports dated July 17, 1930 and February 11, 1931 of the internal revenue agent in charge, Seattle, Washington, to your protest submitted under date of August 19, 1930 and conference held in the agent's office in Portland, Oregon, on October 17, 1930 and January 26, 1931.

As a result of your protest and conference at Portland on January 26, above referred to, certain adjustments were made to your net income resulting in the deficiency of \$3,988.54 as shown in the agent's report dated July 17, 1930 being reduced to \$3,131.58, and you have evidenced your acquiescence in these adjustments by submitting a signed agreement Form 870.

Careful consideration has been accorded your protest in connection with the agent's findings and the reports on the conferences.

The adjustments recommended by the agent in his report of February 11, 1931 as a result of the conference held on January 26, 1931 have been approved with one exception.

Your contention that the so-called debenture preference certificates of the corporation issued to Aaron Holtz were in fact an ordinary obligation of the corporation to the extent of the face value thereof, and that the 6% per annum paid thereon was interest and not a distribution of the earnings of the corporation, cannot be conceded.

It would appear that if only the wording of the stock certificate be considered that the certificate has the nature of an ordinary obligation. It is believed,

however, that the rights granted the certificate holders as evidenced by the by-laws of the [13] company places them in the position of stockholders, as they may exercise certain rights not ordinarily granted a mere creditor of a company.

The evidence presented indicates that the rights of the certificate holder in this case, Mr. Aaron Holtz, are superior to the rights ordinarily granted the holder of cumulative preferred stock; that he exercised all the rights of an ordinary stockholder in the company and that his contribution to the corporation consisted of an investment in the capital stock thereof and was therefore not a loan.

All of the conditions surrounding the existence of borrowed money should be present before the Bureau allows a deduction for interest paid or accrued thereon. Those conditions are not fully present in this case and while it may have been the original intention to issue the stock for the return of a loan, it is quite evident that the so-called creditor who owned the debenture preference stock did not enforce his claims against the corporation as a creditor ordinarily would under the circumstances. He acted more in the capacity of a stockholder.

It is therefore the opinion of this office, after a careful consideration of the data submitted and cases cited, that the debenture preference stock involved represents capital and not borrowed money and that the annual payments in connection therewith are payments of dividends.

Fiscal Year ended January 31, 1928

Net loss reported on return		\$17,822.84
Additional income:		
1. Excessive reserve for bad debts	\$12,995.52	
2. Dividends	1,980.00	
3. Organization expense	495.48	
4. Excessive officers salaries	4,000.00	19,471.00
		<hr/>
Net income as adjusted		\$ 1,648.16

Explanation of Adjustments

1. The addition to the reserve for bad debts as claimed is held to be excessive. The allowable deduction therefor has [14] been computed on the basis of $2\frac{3}{4}\%$ of sales, which is considered a reasonable addition, as follows:

Addition to reserve claimed	\$18,421.13
Amount allowed	5,425.61
	<hr/>
Amount disallowed	\$12,995.52
Article 191, Regulations 74.	

2. Dividends paid by a domestic corporation do not represent an ordinary or necessary expense of doing business as defined in section 23(a) of the Revenue Act of 1928 and accordingly the amount deducted as such has been disallowed.

3. Expenses incident to the organization of a corporation are held to be capital expenses not deductible in determining the corporation's net taxable income. Article 282, Regulations 74.

4. The salary disallowed represents salary paid to M. H. Holtz for the period in excess of an amount which this office considers fair and reasonable; salary has been allowed Mr. Holtz on the basis of \$1,500.00 per month as follows:

Amount claimed	\$10,000.00
Amount allowed	6,000.00
	<hr/>
Amount disallowed	\$ 4,000.00

See section 23(a) of the Revenue Act of 1928.

Computation of Tax

Net income	\$ 1,648.16
Less:	
Exemption (1928—\$2,000.00	
1929— 3,000.00)	2,000.00
	<hr/>
Balance subject to tax	None
Tax assessed	None
	[15]

Fiscal year ended January 31, 1929

Net loss reported on return	\$ 5,202.06
Additional income:	
1. 1928 loss	\$17,822.84
2. Dividends	5,940.00
3. Excessive officers' salaries	12,000.00
4. Excessive reserve for bad debts	1,990.25
	<hr/>
Net income as adjusted	\$32,551.03

Explanation of Adjustments

1. This amount, representing a statutory loss for 1928, was claimed as a deduction under the provisions of section 117 of the Revenue Act of 1928. A final audit disclosed a net income for 1928; therefore, the amount has been restored to income.

2. See explanation #2 of adjustments to income for 1928.

3. The salary disallowed represents salary paid to M. H. Holtz for the year involved in excess of an amount which this office considers fair and reasonable. Salary has been allowed Mr. Holtz on the basis of \$1,500.00 per month as follows:

Amount claimed	\$30,000.00
Amount allowed	18,000.00
	<hr/>
Amount disallowed	\$12,000.00

See section 23(a) of the Revenue Act of 1928.

4. Addition to reserve claimed	\$16,961.42
Amount allowed	14,971.17
	<hr/>
Amount disallowed	\$ 1,990.25

See also explanation #1 of adjustments to income for 1928. [16]

Computation of Tax

Net income	\$32,551.03
Less: Exemption	None
<hr/>	
Amount taxable at 12% and 11%	\$32,551.03
Tax on \$32,551.03 at 12%	\$ 3,906.12
Tax on 32,551.03 at 11%	3,580.61
Tax applicable to 1928—	
11/12 of \$3,906.12	\$ 3,580.61
Tax applicable to 1929—	
1/12 of \$3,580.61	298.38
<hr/>	
Total tax assessable	\$ 3,878.99
Tax previously assessed	None
<hr/>	
DEFICIENCY	\$ 3,878.99

[Endorsed]: Filed Jun. 10, 1931. [17]

[Title of Court and Cause.]

ANSWER.

The Commissioner of Internal Revenue, by his attorney, C. M. Charest, General Counsel, Bureau of Internal Revenue, in answer to the petition of the above-named taxpayer, admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.
2. Admits the allegations contained in paragraph 2 of the petition.

3. Admits the allegations contained in paragraph 3 of the petition.

4(a), (b). Denies the assignments of error contained in paragraph 4, subdivisions (a) and (b) of the petition.

5(a), (b). Denies the allegations contained in paragraph 5, subdivisions (a) and (b) of the petition.

Denies generally and specifically each and every allegation contained in the petition not hereinbefore admitted, qualified or denied.

WHEREFORE, it is prayed that taxpayer's appeal be denied.

(Signed) C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.

Of Counsel:

Byron M. Coon,
R. H. Transue,
Special Attorneys,
Bureau of Internal Revenue.

[Endorsed]: Jul. 17, 1931. [18]

[Title of Court and Cause.]

Docket Nos. 58909, 66268.

Promulgated May 16, 1934.

FINDINGS OF FACT AND OPINION.

1. Petitioner issued so-called "debenture preference stock" which is determined to be evidence of indebtedness rather than stock, and the payments made thereon at the rate of 6

percent per annum are held to be deductible as interest paid.

2. The evidence establishes that amounts equal to $2\frac{3}{4}$ percent of gross sales allowed by respondent as additions to reserve for bad debts are insufficient to cover actual bad debts, and that additions equal to 4 percent of gross sales as claimed by petitioner represent reasonable additions to the reserve.

Roscoe C. Nelson, Esq., for the petitioner.

Warren F. Wattles, Esq., for the respondent.

These proceedings, duly consolidated for hearing, involve deficiencies in income tax for the fiscal years ended January 31, 1929 and 1930, in the respective amounts of \$3,878.99 and \$681.74. A salary question raised by the pleadings was abandoned by petitioner at the hearing, leaving for determination the question of the amounts deductible as additions to a reserve for bad debts for the period ended January 31, 1928, and the fiscal year ended January 31, 1929, and whether amounts accrued and deducted as interest were allowable as such or constituted dividends on preferred stock. No deficiency has been asserted for the period ended January 31, 1928, but it is involved here by reason of the fact that petitioner claims to have sustained a net loss for that period which is carried over and used as a deduction for the succeeding year.

FINDINGS OF FACT.

Petitioner is an Oregon corporation organized on October 6, 1927. Upon its organization it pur-

chased the assets of an existing business known as Proctor's, Incorporated, which was engaged in selling ready to wear women's apparel on the installment basis. Petitioner took over the assets and business as of October 1, 1927, and continued to conduct the business on the installment basis. [19]

Prior to the organization of petitioner several conferences were held between M. H. Holtz, who became president of petitioner, his father, Aaron Holtz, and the attorney for the petitioner on the question of financing the new enterprise. Aaron Holtz was willing to lend the necessary funds to the contemplated organization, but was not willing to accept stock because he desired to be assured that his advances would be repaid, and he also wanted a definite income from the funds. It was deemed inadvisable to issue bonds to cover the loans, as that would affect the credit of the corporation. It was finally decided by the attorney for the petitioner to have the new corporation issue a form of "debenture preference stock" to Aaron Holtz as evidence of the amounts advanced by him. The conclusions of the attorney were set forth in a letter to M. H. Holtz, reading in part as follows:

I have, therefore, reached the conclusion that the best solution would be to create a form of obligation, which we will call for want of a better name, "debenture preference stock." While the certificates will be called "stock", you will understand that it is not stock in any real sense. Labels are of little significance. A

mortgage, for instance, remains a mortgage even though it may be in the form of a deed. The advantage of calling it "stock" is that in your statements to banks and mercantile agencies you need not list it as a liability, because, under the plan I am suggesting, while it will represent a liability as between the corporation and Aaron Holtz, it will not be a liability insofar as concerns the banks and mercantile creditors, because I understand from my talk with him that Aaron Holtz is willing that the banks and mercantile creditors, in the event of insolvency or liquidation take precedence over him. He in turn will take precedence over stockholders.

The so-called "stock certificates" will provide definitely for the payment of interest whether profits are earned or not, so that except for the fact that Aaron Holtz waives his right to share with other creditors until they have been paid, he will be entitled to a definite interest return, and the failure to pay this interest will place him in position to sue the corporation for the principal amount represented by the certificates. As a stockholder, of course, he would have no such right.

Petitioner's articles of incorporation filed with the corporation department of the State of Oregon on October 6, 1927, state that the authorized capital stock consists of 10 shares of common stock of the

par value of \$100 each, and 990 shares of preferred stock of the par value of \$100 each. The preference, rights, privileges, and restrictions on each class of stock are described as follows in the articles of incorporation:

The capital stock of this corporation shall be \$100,000.00 divided into the following classifications:

(a) Debenture preference stock of which there shall be 990 (nine hundred and ninety) shares of the par value of \$100.00 (One Hundred Dollars) each, aggregating \$99,000.00; and

(b) Common stock of which there shall be 10 (ten) shares of the par value of \$100.00 (One Hundred Dollars) each, aggregating \$1,000.00. [20]

Said debenture preference stock shall be entitled to cumulative interest at the rate of six per cent per annum, payable quarterly, commencing October 1, 1927, before any dividends are paid on the common stock, and the common stock is entitled to all dividends in excess of said six per cent. In the event of the dissolution of the corporation or distribution of its assets, the debenture preference stock outstanding at that time shall first be paid at par, plus all accumulated unpaid interest, and the remainder of the corporate assets shall be divided ratably among the holders of the common stock. The voting power at any stockholders' meeting shall be confined exclusively

to holders of common stock. The corporation shall reserve the right to redeem any number or all of the certificates of debenture preference stock at par plus accumulated interest at any time after December 1, 1927. The said corporation shall be bound to redeem monthly, beginning December 1, 1927, debenture preference stock of the par value of \$1500.00 (Fifteen Hundred Dollars) as a minimum. Such retirement, unless same be incidental to liquidation, shall follow the certificates in numerical order. In the event of the issuance of new certificates upon surrender of original certificates, such new certificates shall take the place of those originally issued insofar as the order of redemption is concerned. Failure of said corporation for a period of two years to pay any quarterly interest hereon, as same becomes due and payable, shall render the corporation in default as to such payment and entitle the owners of certificates as to which delinquency occurs, to declare the principal amount of such certificates due and to institute action against the corporation for the par value of said certificates and the accumulated interest thereon. The rights of the holders of debenture preference stock shall, however, be limited in the following respect: In the payment of their several claims all general creditors shall rank superior to the holders of debenture preference stock, but all holders of debenture preference stock shall rank *pari passu* with each other and supe-

rior to holders of any other class of stock of the corporation.

Upon incorporation 990 shares of the stock described as debenture preference stock were issued to Aaron Holtz. The stock certificates for such stock contained on the face of them the provisions above quoted from the articles of incorporation.

In its annual report to the state corporation department for the year ended January 31, 1928, petitioner reported its authorized capital stock to consist of 10 shares of common stock and 990 shares of debenture preference stock, each of the par value of \$100 per share.

Amounts representing 6 percent per annum on the amount of \$99,000 were paid by petitioner to Aaron Holtz, and accrued on its books for the period ended January 31, 1928, and the fiscal years ended January 31, 1929 and 1930. The amounts so paid and accrued have been claimed as interest deductions by petitioner and have been disallowed as deductions by the respondent.

Among the assets which petitioner acquired at October 1, 1927, from its predecessor were accounts receivable which aggregated \$124,686.36. At that time it was determined that at least 12½ percent of such receivables were worthless and petitioner was allowed [21] a discount equal to that percentage amounting to \$15,585.79, the result of which was that petitioner paid \$109,100.57 for the accounts. In making its opening entries petitioner entered the accounts receivable at the face amount of \$124,686.36 and credited the discount of \$15,585.79 to a

reserve for bad debts. Petitioner established a fiscal year basis ending January 31 for filing its income tax returns.

Throughout the years here involved petitioner followed the practice of charging against its reserves for bad debts the amount of those accounts ascertained to be worthless, and crediting to the reserve an amount equal to the total of those accounts upon which no payments had been made for four months or more and which it classified as doubtful accounts. The figures for the several years are as follows:

	1928	1929	1930
Initial reserve	\$15,585.79	\$18,369.94	\$22,518.55
Bad debts	15,636.98	12,812.81	21,331.71
<hr/>			
Balance in reserve	¹ 51.19	5,557.13	1,186.84
Doubtful accounts	18,369.94	22,518.55	21,171.56
<hr/>			
Added to reserve	18,421.13	16,961.42	19,984.72

¹Deficit.

Petitioner's gross sales and the amounts of the additions to reserves for bad debts allowed by the respondent, which additions were based on a percentage of gross sales were as follows:

Period of year ended	Gross sales	Additions allowed	Percent of sales
January 31, 1928	\$197,294.79	\$5,425.61	2¾
January 31, 1929	544,406.09	14,971.17	2¾
January 31, 1930	515,325.80	25,766.29	5

Amounts of \$7,891.79 for the period ended January 31, 1928, and \$21,776.24 for the year ended January 31, 1929, which are equal to 4 percent of gross sales for that period and year, respectively, are reasonable additions to petitioner's reserve for bad debts.

OPINION.

ARUNDELL: The first question is whether petitioner's payments to Aaron Holtz of 6 percent on his "debenture preference stock" were payments of dividends or interest. Petitioner claims that the real relation between it and Holtz was that of debtor and creditor and the annual sums paid are deductible as interest on borrowed money. [22]

This question has been presented a number of times to the Board and the courts under slightly varying facts. In some cases the so-called stock was to be retired at a fixed date, *Arthur R. Jones Syndicate*, 5 B. T. A. 853; reversed, 23 Fed. (2d) 833, and in others at the option of the corporation or the stockholder, *Finance & Investment Corp.*, 19 B. T. A. 643; *affd.*, 57 Fed. (2d) 444. In some cases the interest or dividends were payable regardless of earnings, *Wiggin Terminals, Inc. v. United States*, 36 Fed. (2d) 893, and in others payments were to be made only out of surplus or profits, *Kentucky River Coal Corp. v. Lucas*, 51 Fed. (2d) 586, sustaining 3 B. T. A. 644; *Badger Lumber Co.*, 23 B. T. A. 362; *Elko Lamoille Power Co.*, 21 B. T. A. 291; *affd.*, 50 Fed. (2d) 595. None of the decided cases lay down any comprehensive

rule by which the question presented may be decided in all cases, and "the decision in each case turns upon the facts of that case." *Nowland Realty Co. v. Commissioner*, 47 Fed. (2d) 1018; affirming 18 B. T. A. 405; *Arthur R. Jones Syndicate*, supra; *Garden Homes Co. v. Commissioner*, 64 Fed. (2d) 593, 598. In each case it must be determined whether the real transaction was that of an investment in the corporation or a loan to it. On this the designation of the instrument issued by the corporation, while not to be ignored, is not conclusive, *I. Unterberg & Co.*, 2 B. T. A. 274. The real intention of the parties is to be sought and in order to establish it evidence aliunde the contract is admissible. *Arthur R. Jones Syndicate*, supra. If the evidence establishes "that dividends paid are, according to the intent of the parties, in fact interest, and the stock on which the dividends are paid is merely held by the creditor as security, it makes no difference what the reason was for paying in that form." *Wiggin Terminals, Inc. v. United States*, supra.

In the present case it was obviously the intent of the interested parties that the \$99,000 advanced by Aaron Holtz to the petitioner corporation was to be regarded as a loan. The uncontradicted evidence is that Holtz did not want to stand in the relation of a stockholder of the corporation. He wanted a definite income from the money advanced and assurance that he would be repaid. The only reason for not openly treating the \$99,000 as a

loan was to aid the corporation in obtaining a credit rating. The lender was not restricted to corporate earnings for the return on his advances, and upon default for two years had a right of action against the corporation for both principal and interest. It is our opinion that in reality the relation of Aaron Holtz to the petitioner corporation was that of creditor rather than stockholder. Consequently, the sums representing 6 percent upon his loans are interest and deductible by the petitioner. [23]

The issue on the reserve for bad debts covers the period ended January 31, 1928, and the fiscal year ended January 31, 1929. The fiscal year ended January 31, 1930, is not involved under this issue, although evidence pertaining to that year was introduced.

The amounts claimed by petitioner in its returns for the periods under review, the amounts allowed by the respondent, and the amounts now claimed by petitioner as reasonable additions to the reserve for bad debts are as follows:

	January 31 1928	January 31 1929
Originally claimed	\$18,421.13	\$16,961.42
Allowed	5,425.61	14,971.17
Presently claimed	7,891.79	21,776.24

The amounts now claimed represent 4 percent of gross sales, and the amounts allowed by respondent are $2\frac{3}{4}$ percent of gross sales.

As set out in the findings of fact, the practice of petitioner was to credit to the bad debt reserve an

amount equal to the total of accounts which were delinquent for four months. Against the reserve was charged the actual bad debts. The actual bad debts for the period ended January 31, 1928, were \$15,636.98 and for the fiscal year ended January 31, 1929, they were \$12,812.81, a total of \$28,449.79, against total additions to reserves now claimed in the amount of \$29,668.03, and \$20,396.78 allowed by the respondent. These figures demonstrate that the additions allowed by the respondent were insufficient to care for bad debts and also establish that the amounts now claimed by petitioner are not unreasonable additions. In our opinion the amounts now claimed by petitioner should be allowed as deductions of reasonable additions to its reserve for bad debts.

At the trial of these proceedings a question arose as to the effect of setting up an initial reserve for bad debts in the amount of \$15,585.79 representing 12½ percent of the accounts receivable purchased by petitioner from its predecessor. The evidence develops that the amount so credited to the reserve account has not been charged to earnings or surplus, nor has a deduction ever been claimed in respect of it in petitioner's income tax returns. Petitioner does not now claim any deduction on account of the \$15,585.79 credited to the reserve at the opening of its books, but claims deductions for additions thereto in amounts representing 4 percent of its sales, which we have held above are allowable. The initial reserve does not appear to have

any bearing upon the questions presented for decision.

[Seal]

Decision will be entered under Rule 50. [24]

United States Board of Tax Appeals.

Docket No. 58909.

THE PROCTOR SHOP, INCORPORATED,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION.

Pursuant to the opinion of the Board promulgated May 16, 1934, the respondent herein on July 3, 1934, having filed a proposed recomputation and the petitioner having filed a notice of acquiescence therein, it is

ORDERED and DECIDED that there is a deficiency for the fiscal year ended January 31, 1929, in the amount of \$1,669.28.

Enter:

[Seal]

(s) C. ROGERS ARUNDELL,

Member

[Endorsed]: Entered Jul. 11, 1934. [25]

[Title of Court and Cause.]

PETITION FOR REVIEW AND ASSIGN-
MENTS OF ERROR.

To the Honorable Judges of the United States
Circuit Court of Appeals for the Ninth
Circuit:

NOW COMES Guy T. Helvering, Commissioner
of Internal Revenue, by his attorneys, Frank J.
Wideman, Assistant Attorney General, Robert H.
Jackson, Assistant General Counsel for the Bureau
of Internal Revenue, and John D. Kiley, Special
Attorney, Bureau of Internal Revenue, and respect-
fully shows:

I.

That he is the duly qualified and acting Com-
missioner of Internal Revenue and holding office
by virtue of the laws of the United States; that
The Proctor Shop, Incorporated, the respondent
on review, hereinafter called the respondent, is a
corporation organized and existing under and by
virtue of the laws of the State of Oregon, engaged
in selling ready to wear women's apparel on the
installment basis, with its principal place of busi-
ness at 331 Washington Street, Portland, Oregon;
that the income tax return of said corporation for
the fiscal year ended [26] January 31, 1929 was
filed with the Collector of Internal Revenue for the
District of Oregon and that the office of said Col-
lector is located within the jurisdiction of the
United States Circuit Court of Appeals for the
Ninth Circuit.

II.

The nature of the controversy is as follows, to-wit:

Respondent is an Oregon corporation organized on October 6, 1927. Upon its organization it purchased the assets of an existing business known as Proctor's, Incorporated, which was engaged in selling ready to wear women's apparel on the installment basis. Respondent took over the assets and business as of October 1, 1927, and continued to conduct the business on the installment basis.

Prior to the organization of respondent several conferences were held between M. H. Holtz, who became president of respondent, his father, Aaron Holtz, and the attorney for the respondent on the question of financing the new enterprise. Aaron Holtz was willing to lend the necessary funds to the contemplated organization, but was not willing to accept stock because he desired to be assured that his advances would be repaid, and he also wanted a definite income from the funds. It was deemed inadvisable to issue bonds to cover the loans, as that would affect the credit of the corporation. It was finally decided by the attorney for the respondent to have the new corporation issue a form of "debenture preference stock" to Aaron Holtz as evidence of the amounts advanced by him.

Respondent's articles of incorporation filed with the corporation department of the State of Oregon on October 6, 1927, state that the authorized capital stock consists of 10 shares of common stock of

[27] the par value of \$100 each, and 990 shares of preferred stock of the par value of \$100 each. Upon incorporation 990 shares of the stock described as "debenture preference stock" were issued to Aaron Holtz.

Amounts representing 6 percent per annum on the amount of \$99,000 were paid by respondent to Aaron Holtz, and accrued on its books for the period ended January 31, 1928, and the fiscal year ended January 31, 1929. The amounts so paid and accrued have been claimed as interest deductions by respondent and have been disallowed as deductions by the Commissioner.

The Commissioner determined a deficiency in Federal income tax against the respondent for the fiscal year ended January 31, 1929 in the amount of \$3,878.99, and on April 30, 1931 sent to it by registered mail notice of said deficiency in accordance with the provisions of Section 272 of the Revenue Act of 1928; that thereafter on June 10, 1931 the respondent filed an appeal from said notice of deficiency with the United States Board of Tax Appeals.

On September 28, 1933 the case was submitted to the United States Board of Tax Appeals for its decision. On May 16, 1934 the Board promulgated its opinion and on July 11, 1934 entered its decision and redetermination in accordance with its opinion, wherein and whereby it was ordered and decided that there was a deficiency in tax for the fiscal year ended January 31, 1929 in the amount of \$1,669.28.

The Commissioner being aggrieved by the conclusions of law contained in said opinion and by said final decision, desires to obtain a review thereof by the United States Circuit Court of Appeals for the Ninth Circuit. [28]

III.

The Commissioner's assignments of error are as follows:

1. The Board of Tax Appeals erred in determining that the sum of \$5,940.00 paid during the fiscal year ended January 31, 1929 constituted interest on indebtedness, and as such was deductible from income.

2. The Board of Tax Appeals erred in determining that the so-called "debenture preference stock" of the respondent constituted indebtedness of the taxpayer.

3. The Board of Tax Appeals erred in its failure and refusal to hold that the sum of \$5,940.00 paid by the respondent during the fiscal year ended January 31, 1920 constituted the payment of a dividend.

4. The Board of Tax Appeals erred in its failure and refusal to hold that the so-called "debenture preference stock" of the respondent was in fact and in law preferred stock.

5. The Board of Tax Appeals erred in determining that there was a statutory net loss for the fiscal year ended January 31, 1928 in the amount of \$2,798.02 deductible from respondent's net in-

come for the fiscal year ended January 31, 1929 in that the Board erred in holding and determining that the sum of \$1,980.00 paid during the fiscal year ended January 31, 1928 to Aaron Holtz constituted the payment of interest on indebtedness.

6. The Board of Tax Appeals erred in determining that there was a deficiency in tax for the fiscal year ended January 31, 1929 in the amount of \$1,669.28.

7. The Board of Tax Appeals erred in its failure and refusal to determine that there was a deficiency in tax for the fiscal year ended [29] January 31, 1929 in the amount of \$3,878.99.

WHEREFORE, he petitions that a transcript of the record be prepared in accordance with the rules of the United States Circuit Court of Appeals for the Ninth Circuit, and transmitted to the Clerk of said Court for filing and appropriate action be taken to the end that the errors complained of may be reviewed and corrected by the United States Circuit Court of Appeals for the Ninth Circuit.

(Sgd) FRANK J. WIDEMAN,

Assistant Attorney General.

(Signed) ROBERT H. JACKSON,

Assistant General Counsel for the
Bureau of Internal Revenue.

Of Counsel:

John D. Kiley,

Special Attorney,

Bureau of Internal Revenue.

United States of America,
District of Columbia—ss:

JOHN D. KILEY, being duly sworn, says that he is a Special Attorney in the office of the Assistant General Counsel for the Bureau of Internal Revenue and as such is duly authorized to verify the foregoing petition for review; that he has read said petition and is familiar with the contents thereof; that said petition is true of his own knowledge except as to the matters therein alleged on information and belief, and as to those matters he believes it to be true.

(Sgd) JOHN D. KILEY.

Sworn and subscribed to before me this 5th day of October, 1934.

[Seal] (Sgd) GEORGE W. KILES,
Notary Public.

My commission expires Nov. 16, 1937.

[Endorsed]: Filed Oct. 5, 1934. [30]

[Title of Court and Cause.]

NOTICE OF FILING PETITION
FOR REVIEW.

To:

The Proctor Shop, Incorporated,
331 Washington Street,
Portland, Oregon.

R. C. Nelson, Esq.,
800 Pacific Bldg.,
Portland, Oregon.

You are hereby notified that the Commissioner of Internal Revenue did, on the 5th day of October, 1934, file with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Ninth Circuit, of the decision of the Board heretofore rendered in the above-entitled case. A copy of the petition for review and the assignments of error as filed is hereto attached and served upon you.

Dated this 5th day of October, 1934.

(Signed) ROBERT H. JACKSON,
Assistant General Counsel for the
Bureau of Internal Revenue.

Personal service of the above and foregoing notice, together with a copy of the petition for review and assignments of errors mentioned therein, is hereby acknowledged this 9th day of October, 1934.

(Sgd) THE PROCTOR SHOP, INC.,
Merriman H. Holtz, Pres.,
Respondent on Review.

(Sgd) ROSCOE C. NELSON,
Attorney for Respondent on Review.

[Endorsed]: Filed Oct. 16, 1934. [31]

[Title of Court and Cause.]

PRAECIPE FOR RECORD.

To the Clerk of the United States Board of Tax Appeals:

You will please prepare, transmit and deliver to the Clerk of the United States Circuit Court of Appeals for the Ninth Circuit, copies duly certified as correct of the following documents and records in the above-entitled cause in connection with the petition for review by the said Circuit Court of Appeals for the Ninth Circuit, heretofore filed by the Commissioner of Internal Revenue:

1. Docket entries of the proceedings before the Board.
2. Pleadings before the Board.
 - (a) Petition, including annexed copy of deficiency letter.
 - (b) Answer.
3. Findings of fact, opinion and decision of the Board.
4. Petition for review, together with proof of service of notice of filing petition for review and of service of a copy of petition for review.
5. Orders enlarging time for the preparation of the evidence and for the transmission and delivery of the record. [Not included in record.] [32]

(Signed) ROBERT H. JACKSON,
Assistant General Counsel for the
Bureau of Internal Revenue.

Counsel for respondent on review concurs in this praecipe for record.

(Sgd) ROSCOE C. NELSON,
Counsel for Respondent.

Service of a copy of the within praecipe is hereby admitted this 5 day of December, 1934.

(Sgd) ROSCOE C. NELSON,
Counsel for Respondent.

[Endorsed]: Filed Dec. 13, 1934. [33]

[Title of Court and Cause.]

CERTIFICATE.

I, B. D. Gamble, clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 33, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 31st day of December, 1934.

[Seal]

B. D. GAMBLE,

Clerk,

United States Board of Tax Appeals.

[Endorsed]: No. 7734. United States Circuit Court of Appeals for the Ninth Circuit. Commissioner of Internal Revenue, Petitioner, vs. The Proctor Shop, Inc., Respondent. Transcript of the Record. Upon Petition to Review an Order of the United States Board of Tax Appeals.

Filed January 8, 1935.

PAUL P. O'BRIEN,
Clerk of the United States Circuit Court of Appeals
for the Ninth Circuit.